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Under Secretary Wallis

Current
Policy
No. 804

Structural Adjustment and the Trading System: Europe's Role

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United States Department of State
Bureau of Public Affairs
Washington, D.C.

APR 14 1986
U.S. GOVT. PRINTING
DEPOSITORY 378

Following is an address by Allen Wallis, Under Secretary for Economic Affairs, before the London Chamber of Commerce, London, March 7, 1986.

At the Tokyo economic summit May 4–6, 1986, one of the important issues that will be discussed is the relationship of economic growth to structural adjustment and the efficient operation of markets. Since I am in London to help prepare for the summit, I am especially pleased to have this opportunity to give you an American's perspective on Europe's role in structural adjustment and the relation of that to the international trading system. My central point is that policies which inhibit adjustment to change not only hamper domestic economies but also damage global trade and economic growth.

In Europe, the United States is the usual scapegoat for international economic problems. In particular, our Federal government's budget deficit is often described as the root of all the world's economic ills and most of its imperfections. Whether or not there is an element of truth in the scapegoating, it certainly is true that the United States can make a major contribution to the health of the world economy, and the main way we can do that is to keep our own economy strong. Our four principal economic priorities are:

- To increase competition by continuing to deregulate our domestic economy;
- To reduce the drag of government by curtailing the growth of government expenditures;
- To reform our tax system so as to strengthen incentives to work, to save, and to invest; and
- To resist protectionism at home and abroad, in part, through a new round of international trade negotiations.

EUROPE AND THE WORLD ECONOMY

Europe has responsibilities in the international economic system second only to America's. Europe faces profound challenges in the remainder of the century, many of them with international repercussions. Europe's high average unemployment, now at 11.2% EC [European Community]-wide, masks regional pockets of even higher unemployment, youth unemployment levels over 20% in most countries, and growing longer term unemployment. Increasingly, my European colleagues identify structural problems as major reasons for Europe's failure to create new jobs in recent years and promote new, dynamic industries—such problems as overly generous unemployment and employee benefits packages, rigid hiring and firing practices, housing programs that hamper worker mobility, disincentives to employment-generating investment, and interference with business decisions on when and where to open or close plants.

Key sectors of Europe's markets have been closed to import competition in efforts to protect existing jobs, especially in such sectors as agriculture, telecommunications, steel, and automobiles. By freezing labor and capital into inefficient activities, Europe has reduced its opportunities to grow and expand into more dynamic activities where it might compete better in international markets.

We view these developments with alarm for two reasons.

First, as your friend and strategic partner, we care about European security, prosperity, and liberty. Such practices have made those economies more rigid, less able to adjust to change, and hence less dynamic than they otherwise could be. Economic weakness, in turn, diminishes the alliance's ability to meet its joint security responsibilities.

Second, as your economic and trading partner, we see from a different perspective than you the disruptive impact of European practices on the international economy. In particular, Europe's rigid economies and anemic growth have generated protectionist pressures to insulate your inefficient industries from overseas competition. Imports are restricted, exports are subsidized, and the industries concerned become even more inefficient, requiring even more protection. These policies not only retard economic growth in Europe but also generate adverse effects on Europe's trading partners.

Agriculture

European agriculture is a case in point. We acknowledge, of course, the historic importance of the Common Agricultural Policy (CAP) in forging European unity. Our quarrel is not with the CAP, but with the manner in which it is being implemented, its effect on European growth, and its impact on international trade. "We believe," in the words that Michael Jopling [U.K. Minister of Agriculture, Fisheries, and Food] used

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in an excellent speech in Washington last Tuesday, "that the CAP poses serious problems for the Community's consumers, its taxpayers and its trading partners." But, like Minister Jopling, we "do not accept that the policy itself is illegitimate."

The CAP has evolved into an entitlement program under which government assures a market for virtually all EC agricultural production at prices far above world levels. These high price supports have been accompanied by variable levies and other import restraints. The excess production stimulated by the high prices is then dumped on world markets through export subsidies. Imports are reduced and exports expanded, all at the expense of its trading partners.

For example, despite relatively inefficient farms and high production costs in a number of member states, EC wheat production recently has averaged about 130% of self-sufficiency. The Community's imports of wheat have fallen to less than one-third the levels of the 1970s. Its subsidized wheat and wheat flour exports have increased nearly sevenfold and now take some 17% of world markets.

The opportunity cost is an enormous burden for Europe to bear. The direct budgetary cost of EC agricultural supports and subsidies has grown to over $18 billion annually. More important, the indirect costs—that is, the total transfer to farmers from European taxpayers and consumers—are estimated to be on the order of $60–$70 billion annually. Roughly 60% of the value added in European agriculture is now attributable to these transfers and subsidies. The United States, of course, also supports agriculture, but our income payments are combined with acreage reduction programs to reduce production.

There can be no doubt about the effects of protection on such a large scale. By keeping internal EC prices higher than market forces justify, the CAP fosters excessive levels of production and investment in agriculture, siphoning off funds that could be used more productively elsewhere in the economy. Employment in agriculture is maintained at an artificially high level. Not including Spain and Portugal, agriculture accounts for 7.7% of total civilian employment in the EC compared with just 3.6% in the United States. The jobs "saved" in agriculture and other protected areas are more than offset by the greater number of jobs lost (or never created) in other sectors of the economy. For example, while the U.S. economy created over 27 million net new jobs during the last 15 years, Europe actually lost jobs, and European unemployment increased fivefold. The irony is that such a situation makes many in the Community even more reluctant to undertake necessary CAP reforms out of fear that displaced farmers would have nowhere to go.

The CAP also generates direct negative effects on international trade. A study commissioned by the Australian Government estimates that EC policies have depressed international prices for temperate zone agricultural products by 16%. Despite the fact that its production costs for these products are high, the EC has become one of the largest growers and exporters of wheat and the largest exporter of poultry, eggs, beef, veal, refined sugar, and dairy products. Every increment to EC output of these products has cost European taxpayers and consumers dearly.

Moreover, subsidized EC exports take away markets from the Community's nonsubsidizing trading partners. For example, subsidized EC grain exports cost other grain-exporting countries some $2–$3 billion annually in lost sales. The EC's sugar program costs other sugar producers, including some of the poorest LDCs [less developed countries], several hundred million dollars annually in lost revenues.

The CAP has undercut support for free trade among U.S. farmers, traditionally a pillar of the free trade coalition in the United States. Farm state legislators strongly insisted that our new farm legislation mandate export subsidies to help American farmers recover lost markets. President Reagan opposed those provisions and will seek their modification. However, the provisions became law because of the frustration of farmers and the Congress with obstacles to U.S. exports and lack of progress toward serious negotiations on agricultural trade.

We are concerned also about certain EC agricultural trade measures taken in connection with the enlargement of the Community to include Spain and Portugal. As you know, the United States has long supported the entry of those countries into the EC, and we congratulate the Community, as well as the two countries, on their accession. As a consequence of enlargement, however, the United States now faces major new restrictions on its agricultural exports to Iberia. These include high variable levies on Spain's grain imports, where before there were fixed tariffs bound under GATT [General Agreement on Tariffs and Trade]; Portuguese import quotas on soybeans and other oilseeds; and a requirement that Portugal guarantee its other EC partners some 15%–16% of its grain market. These measures cover about $1 billion worth of annual U.S. exports to Iberia. They have been implemented by the Community without adequate GATT notification or review and before negotiations over compensation that are required by the GATT. Moreover, the quantitative restrictions imposed on Portugal simply are not permitted by the GATT. It is essential that the EC respond quickly to our concerns if we are to avoid a major trade dispute.

Primarily as a result of agricultural policies in the United States and Europe, there is global oversupply of virtually every major commodity. Nevertheless, the EC continues to expand production and, in so doing, shifts to others the burden of adjustment.

We need to change our ways. In its new farm legislation, the United States has begun to move slowly but surely toward more market-oriented agricultural policies. Price supports have come down and will go down further. We are doing this for sound reasons of domestic policy, not to attack the CAP, but it must be recognized that an indirect effect of our new policies will be to raise the cost of the CAP subsidies.

In recent years the high value of the dollar has sheltered the CAP from the full effects of U.S. efficiency in agriculture. Since the dollar peaked last February, it has declined about 30% against the ECU. Further strengthening of Europe's currencies relative to the dollar would increase further the cost of the CAP and put greater pressure on EC policies and budgets. Already, the EC Commission has indicated that a 750 million ECU supplementary budget will be needed for the CAP this year to offset the effect of the dollar's decline. That will be 750 million ECU which will not be available for use in developing greater competitiveness in other sectors. Would not CAP reform be a better course of action?

Reform will be difficult. But in confronting the task, Europe should recognize the opportunities as well as the difficulties. Putting agriculture on a more market-oriented basis would provide important economic benefits to Europe. It would release for more productive purposes capital and labor now used relatively inefficiently. It would lower costs confronted by nonagricultural enterprises and improve their competitiveness. It would increase European incomes and foster a more dynamic, growth-oriented economy. By facilitating a better international division of labor based on comparative advantage, it would help the world economy achieve higher levels of growth.

Beyond our internal efforts, we need effective GATT rules against the use of export subsidies in agricultural trade, as well as new rules on market access. This is one of the priorities for the United States in the new trade round, and, for the reasons I have outlined, I believe that it is at least as important for the EC.

Basic Industries

A similar situation exists in basic manufacturing industries. Consider steel. Technological and economic change has had a major impact on the steel industry. Much of the steel capacity in industrial countries is becoming obsolete. At the same time, growth in demand for steel has not kept pace with overall economic growth. World steel capacity substantially exceeds world demand for steel. Secretary of Commerce Baldrige has estimated that excess capacity currently approaches 200 million metric tons. As we move toward an economy based on information and services, and apply more sophisticated techniques to manufacturing and construction, less steel will be needed for each additional increment of gross national product. The market's message is clear.

On both sides of the Atlantic, restructuring and reducing the steel industry is a difficult task, involving a substantial loss of jobs. We estimate that U.S. steel firms, for example, have shed almost 50% of their jobs since 1979. Europe, according to the OECD [Organization for Economic Cooperation and Development], has shed about 40% of total jobs in steel industries over a longer, 10-year period.

We will have to rationalize our steel industries further. The EC steel restructuring plan had some success in closing outmoded facilities and rationalizing production. This plan called for an end to government subsidies as of January 1, with exceptions to meet environmental regulations, conduct research and development for certain purposes, and assist in plant closings, as well as to provide regional aid in some circumstances. Production quotas are to be removed from a few products.

However, EC governments have carried out the steel plan unevenly. British steel is among the more successful; it has reduced its workforce from 210,000 in 1975 to 64,000 today and is now profitable. German efforts similarly have resulted in more efficient and profitable steel plants. Some other countries, however, are sluggish. Already $29 billion in public funds have been spent on subsidies to European steel industries during the last 10 years. Some countries appear willing to continue to spend funds to protect jobs in inefficient plants, rather than to use those funds more wisely to create jobs in other sectors.

The United States and other countries are affected by this hesitancy to rationalize. Europe's steel imports have been held down to about 5% of demand, while the United States permitted its imports to reach about 25% of total domestic demand in 1984 and 1985. The EC accounted for about 20% of U.S. steel imports in those 2 years. Since much of Europe's steel production was subsidized, exports to the United States, in effect, spread the distorting effect of these subsidies to the disadvantage of U.S. steel producers.

We are also affected by European sales of steel projects to LDCs. New mills, frequently financed with the help of subsidized credit, exacerbate the problems by contributing further to excess world steel capacity. LDC steel exporters, however, have not been given a fair opportunity to market their steel in the EC. As a result, they turn to the more open U.S. market and thus feed protectionism in the United States.

In steel, as in agriculture, costly policies insulate the European industry from foreign competition; they subsidize inefficient production; and they generate serious distortion of the world economy. In view of the outlook for the steel industry, it is not too soon for governments in Europe and the United States to consider methods and timetables for getting governments out of the international steel industry when the current U.S. program expires and relying on the market to direct the allocation of resources in this important industry.

High Technology

Protection of agriculture and heavy industries inevitably limits Europe's ability to shift resources into activities such as high technology. In fact, Europe's position in many fields of technology has eroded. The EC estimates that the Community's share in OECD high-technology manufactured exports fell from 58% in 1963 to 43% in 1983. If Europe wishes to keep up in the race for the future, it will have to abandon some relics of the past.

To be sure, European nations and the EC have great interest in policies to promote high technology and emerging industries. But to American eyes, Europe's efforts seem to be headed in the wrong direction. In our experience, innovation thrives in a climate that fosters risk-taking, entrepreneurship, and competition. We believe that the "magic of the market" will channel innovative energies and resources into the most productive channels.

Many Europeans seem to believe that Europe can compete only by resorting to an "industrial policy." They advocate forming intergovernmental consortia and pouring in large amounts of public funds. In our view, this is a recipe for expensive white elephants. Such large multigovernment efforts tempt governments to protect their new elephants by restricting competitive imports. We see this unhealthy tendency also afflicting new products developed by Europe's private firms, such as in consumer electronics, where the EC nearly doubled tariffs on video cassette recorders to insulate its market from Asian competition. We are particularly distressed also by restrictions on market access in such sectors as telecommunications, where the United States is highly competitive.

Trade in civil aircraft is another high-technology area where both the United States and Europe have important interests in ensuring that trade and competition are free and fair. As you know, the United States objects to government subsidies of the development and sale of commercial aircraft and to political inducements for their purchase. These activities have distorted the competitive environment and are contrary to the GATT agreement on trade in civil aircraft. It is clear that we need to develop better understandings on the observance of the GATT aircraft code. We are pleased, therefore, that later this month we will be meeting with representatives from the European governments concerned to discuss this issue.

Availability of venture capital to entrepreneurs willing to undertake risks is also important to the rapid development of new high-technology industries, especially for small firms. Numerous representatives of European governments and industries, struck by the successful example of the United States, are looking to venture capital to help facilitate innovation. Venture capital markets have expanded rapidly in some European countries in the last few years, notably the United Kingdom and the Netherlands. Most markets remain relatively small, however, and most are dominated by conservative financial institutions which prefer to lend to larger enterprises, often state run. The markets are still hampered also by tax law disincentives, by absence of uniform financial practices throughout the EC, and by excessive regulation.

TOWARD A BETTER GLOBAL BALANCE

It is widely agreed that there needs to be a better balance in a number of areas of the international economy. At the Bonn economic summit meeting, and later at the September 22 G–5 [Group of 5—Federal Republic of Germany, France, Japan, United Kingdom, and United States] meeting in New York, the major industrial countries identified these imbalances as including the large U.S. trade deficit; the appreciation of the U.S. dollar; and the large, growing current account surpluses of Japan and Germany. The participants identified respective national economic measures that would contribute to improved international economic balance. Vigorous implementation of those measures would lead to stronger economic growth in Europe and would enhance the sustainability of growth in the United States and Japan.

Notwithstanding frequent press comments to the contrary, the United States does not advocate that Europe reflate through old-fashioned pump-priming. Rather, we believe that Europe should strengthen its overall economic performance by hastening the pace of structural adjustment, by letting domestic markets work more freely, and by opening up to competition, foreign and domestic. We also advocate rearranging tax structures, where possible, to reduce the drag on the economy. Tax cuts, such as those planned for the United Kingdom and the Federal Republic of Germany, can improve growth and generate employment.

We realize that the United States, too, has an essential role to play. At Bonn, President Reagan said that his principal domestic objectives were "to achieve a rapid and appreciable cut in public expenditures and thus a reduction in the budget deficit." He also stressed "the need for further deregulation and for a reform of the tax system aimed at encouraging the efficient use of resources." A great deal has been accomplished in each of these areas during the 10 months since the Bonn summit, and I assure you that we intend to do much more.

Since Bonn, the summit countries have made significant progress on trade. President Reagan has blocked protectionist measures, most notably in footwear and textiles. Together we achieved in Geneva in November an international consensus that there should be a preparatory committee to work out the agenda and modalities for a new round of trade negotiations. That committee has now started its work, and we hope that the new round will be launched in September.

Let's not let our problems obscure the fact that by building on this progress we can reinvigorate our markets and make our domestic economies more productive. Not only can we do it, we are doing it. We recognize that change is not only inevitable but also desirable and that our future lies in exploiting change, not hampering it. Adjustment to change is not easy, but one region's resistance to change not only saps its own vitality but also endangers the open international economic system on which the prosperity of all of us depends. ■

Published by the United States Department of State • Bureau of Public Affairs
Office of Public Communication • Editorial Division • Washington, D.C. • March 1986
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